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In The

SUPREME COURT OF THE UNITED STATES

October Term, 1972

No. _____

THE WESTERN AND SOUTHERN LIFE INSURANCE COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Petitioner, The Western and Southern Life Insurance Company, respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Sixth Circuit, entered in this proceeding on May 12, 1972, petition for rehearing *en banc* denied on July 12, 1972.

OPINIONS BELOW

The opinion of the Court of Appeals for the Sixth Circuit (Appendix A, *infra* pp. 13-23) is reported at 460 F.2d 8. The opinion of the United States Tax Court (Appendix B, *infra*, pp. 35-50) is reported at 55 T.C. 1036.

JURISDICTION

The judgment of the Court of Appeals (Appendix A, *infra*, p. 24) was entered on May 12, 1972. A timely petition for rehearing *en banc* was denied on July 12, 1972 (Appendix A, *infra*, p. 36). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254 (1).

QUESTIONS PRESENTED

1. Whether the Court of Appeals incorrectly held that in valuing the assets of the petitioner as defined in § 805 (b) (4) of the Internal Revenue Code for purposes of applying the statutory formula to determine its taxable investment income there should be included the "loading" portion of premiums on outstanding insurance policies not paid at the end of the taxable year.

2. Whether the Court of Appeals incorrectly held that the petitioner was not entitled to exclude or offset from its gain from operations, as determined under § 809 (b) of the Internal Revenue Code, the amount of the increase in "loading" on premiums not paid at the end of the taxable year.

STATUTORY PROVISIONS INVOLVED

This case involves portions of § 2 of the Life Insurance Company Income Tax Act of 1959, 73 Stat. 112-141, specifically 26 U.S.C. §§ 802 (b), 804, 805, 809 and 818 (a). These are reprinted in pertinent part in Appendix C, *infra*, pp. 53-74).

STATEMENT OF THE CASE

Petitioner is a mutual life insurance company and as such is subject to the Life Insurance Company Income Tax Act of 1959, §§ 801 *et seq.* of the Internal Revenue Code (R. p. 156). In essence that Act levies a tax on what is computed to be the company's (rather than the policyholders') share of investment income (the Phase I Tax) and a tax on what is computed to be the overall gain from operations (the Phase II Tax) (R. p. 162). In computing its federal income tax liability for the years 1958 to 1962, inclusive, petitioner did not include in its assets unpaid premiums on policies in force at the end of its taxable year (R. p. 160). Petitioner also excluded from its gain from operations the amount of the increase in "loading" on such premiums for each year (R. pp. 160-61).

At the end of any taxable year, petitioner has life insurance policies in force, the premiums on which for the full current policy year have not been paid, either because premiums are being paid in less than annual installments, because the grace period allowed for payment has not expired, or because the policyholder has decided not to pay the premium (R. p. 157; Appendix A, *infra*, p. 15). Petitioner has no legal right to collect such unpaid premiums. However, state law requires petitioner to provide reserves to meet the potential liability on such policies in the event of death while the policy is still in force, which reserves are treated as liabilities under state law (R. p. 158).

The amount which goes into the reserve for each policy is the "net valuation premium"—that actuarily determined amount of money which, using the mortality table and interest rate assumed for the policy, will be exactly sufficient to provide the benefits of the policy (R. p. 156). The excess of the contract premium (the amount charged the policy-

holder) over the net valuation premium is called "loading", and is an amount determined by independent judgment of the insurer to cover estimated management and operating expenses, commissions, contingencies, profit in the case of capital stock companies, and dividends in the case of mutual companies such as petitioner (R. p. 157). "Loading" is never considered by the petitioner's actuaries in determining the net valuation premium of a particular policy or class of policies and bears no fixed relationship to the net valuation premium (R. pp. 27-28, pp. 156-57). The issues in this case involve the loading on premiums not paid at the end of the year.

The Commissioner of Internal Revenue assessed income tax deficiencies against petitioner for all of the years in question (R. pp. 15-24), contending that petitioner had treated the unpaid premiums erroneously, for both the Phase I and Phase II tax computations prescribed by the Life Insurance Company Income Tax Act. The Commissioner asserted that petitioner was required to include in its assets for Phase I computations the gross amount of premiums unpaid at the end of each taxable year (Appendix B, *infra*, p. 42) and also to include the gross amount of such premiums in its income for the purpose of determining the Phase II tax on gain from operations (Appendix B, *infra*, p. 47).

Petitioner filed a timely Petition in the United States Tax Court (R. pp. 3-14). In the Tax Court, petitioner conceded that an amount equal to the "net valuation premium" should be included in its assets for purposes of the Phase I tax, and that the same amount should be included in the gross premiums received for purposes of the Phase II tax (R. pp. 160-61). This concession conforms to the life insurance industry position advanced by *amici curiae* in this case and is consistent with the position of the

National Association of Insurance Commissioners, the group composed of state insurance commissioners prescribing the form of annual statement required by § 818 (a) of the Internal Revenue Code (R. pp. 159-60; Appendix A, *infra*, p. 39).

Section 802 (b) of the Internal Revenue Code provides a three-phase method of computing a life insurance company's taxable income. It is only the first two phases of that computation and the validity of the Treasury Regulations interpreting the applicable sections of the Internal Revenue Code which are involved in this case.

Phase I Issue

In computing the first segment of the taxable income of a life insurance company, its taxable investment income, a portion of the company's investment income, designated as the policyholders' share of investment yield, is excluded. An important factor in making the allocation between taxable investment income and the policyholders' share of investment yield is a fraction, the numerator of which includes life insurance reserves, and the denominator of which includes the assets of the company. Naturally, the smaller the denominator, the larger the fraction, and under the statutory formula provided in § 804, the smaller the Phase I tax. Thus, if the value of the assets of the company is increased, the tax liability is also increased. The Commissioner asserts that because in such computation petitioner includes in its reserves an amount for policies the premiums on which have not been paid, it must also include in its assets an amount equal to the gross premium on such policies, including loading (R. pp. 164-65).

Phase II Issue

The second step in the computation of the taxable income of a life insurance company involves the calculation

of gain from operations under § 809 (b). Under § 809 (c) (1), gain from operations includes the gross amount of premiums received by the company. Petitioner excluded from the gross amount of premiums the amount which represented the increase in loading on unpaid premiums. The Commissioner asserts that because § 809 (d) provides for a deduction for increases in reserves in computing gain from operations, the increase in loading on unpaid premiums must be included in gross premiums received by the company (R. pp. 170-71).

The Tax Court held that in computing the assets of petitioner under § 805 (b) (4) there should be excluded the loading portion of unpaid premiums (R. pp. 169-70; Appendix B, *infra*, p. 46), and that petitioner is entitled to exclude from gain from operations, as determined under § 809 (b), the amount of the increase in loading on unpaid premiums (R. p. 172; Appendix B, *infra*, p. 48). The Court of Appeals for the Sixth Circuit reversed (Appendix A, *infra*, p. 24). A timely petition for rehearing *en banc* was filed (Appendix A, *infra*, pp. 25-33) and denied on July 12, 1972 (Appendix A, *infra*, p. 34).

REASONS FOR GRANTING THE WRIT

1. The decision of the Court of Appeals in this case is in direct conflict with several decisions of the United States Tax Court, which has remained steadfast in its judgment despite adverse decisions in the Courts of Appeal and, as will be pointed out below, it appears to be in conflict with the most recent pronouncement of the Court of Appeals for the Fifth Circuit.

In *Western National Life Insurance Company of Texas* v. *Commissioner*, 50 T.C. 285 (1968), *modified*, 51 T.C. 824 (1969), *rev'd*, 432 F.2d 289 (5th Cir. 1970), the Tax Court first held that neither the unpaid premiums nor the

loading portion of such premiums were assets. Subsequent to that decision, the Tax Court granted the Commissioner's motion to reconsider the original decision in light of the decision of the Court of Appeals for the Seventh Circuit in *Franklin Life Insurance Company* v. *United States*, 399 F.2d 757 (7th Cir. 1968), *rev'g* 67-2 U.S.T.C. ¶ 9515 (S.D. Ill. 1967). Upon such reconsideration and after oral argument by the parties and the appearance as *amicus curiae* of the two national associations of life insurance companies who also appeared as *amicus curiae* in this case below, the Tax Court modified its earlier decision, adopted the industry position and held that the net valuation premiums should be included in assets, refusing to follow the decision of the Seventh Circuit that loading was also an asset (51 T.C. 824).

The present case was originally decided by the Tax Court in 1971 after the above cited cases, and after a similar decision of another United States Court of Appeals, *Jefferson Standard Life Insurance Co.* v. *United States*, 408 F.2d 842 (4th Cir. 1969). Thus, in the face of the Fifth Circuit's reversal of the Tax Court's *Western National* decision, and adverse decisions in the Fourth and Seventh Circuits, the Tax Court in this case below still adhered to its decision that loading is not an asset and that petitioner is entitled to exclude it in computing gain from operations. The entire panel of the Tax Court remained firm in their interpretation of the law; every judge agreed with the position taken by petitioner. The Tax Court, which has considered the question three times, is made up of experts in the field of federal taxation and is not lacking in respect for the Courts of Appeal. Yet, to a man, the judges comprising that Court remained convinced of the rectitude of their decision.

Furthermore, the United States Court of Appeals for the

Fifth Circuit, upon whose decision in *Western National, supra,* the Court of Appeals below has so heavily relied, itself has indicated by analogy that despite its own earlier decision to the contrary, loading on unpaid premiums is not part of a life insurance company's assets under Internal Revenue Code § 805 (b) (4). In *Liberty National Life Insurance Company* v. *United States,* No. 71-2776 (5th Cir., July 12, 1972), 72-2 U.S.T.C. ¶ 9551, the Court held that escrow mortgage funds were not § 805 (b) (4) assets to be used in computing a life insurance company's taxable investment income because they were trust funds held for the use of mortgagors and could not be used by Liberty National for investment. The Court cited with approval the language of the Tax Court in the first *Western National Life Insurance Company* case (50 T.C. 285, 298) dealing with unpaid premiums:

> They do not currently yield any income. They cannot and are not used to produce investment income; and . . . should not be included in the formula used to determine the rate of return on the company's investment assets. *Id.*

The court after quoting the foregoing language said:

> We are in accord with that philosophy . . . . To say that section 805 (b) (4) encompasses only assets of the company is but another way of saying that to be deemed an asset an item must be both available for and capable of investment. 72-2 U.S.T.C. ¶ 9551.

The Court stated that the government had urged that such a decision would be inconsistent with the earlier appellate court decisions, including that of the Fifth Circuit itself, involving unpaid premiums. Nevertheless, the Court embraced the language of the Tax Court's earlier decision in *Western National.* In attempting to differentiate the

unpaid premiums decisions, the Court used an example (*id.*, footnote 9) of the asset and reserve computation for unpaid premiums that offset the reserve with an *equal* amount of unpaid premiums — which constitutes the net valuation premium and excludes loading.

We urge therefore, that although there exists no conflict in decisions in the Circuits directly involving the issue of loading on unpaid premiums, there does exist not only an ongoing controversy between the Tax Court and several of the Courts of Appeal, but also a conflict between the Courts of Appeal for the various circuits, since the most recent decision of the Fifth Circuit conflicts with the decision here under review. Such conflicts will undoubtedly continue until the question is finally put to rest by this Court.

2. The questions presented are of importance to the administration of the federal tax law. They are universal in the life insurance industry. Every life insurance company is subject to The Life Insurance Company Income Tax Act of 1959, and every life insurance company has in force at the end of its taxable year existing policies on which the premiums are unpaid. Thus, this is not an isolated occurrence in the taxation of life insurance companies. It takes place every year for every life insurance company in the country.

In addition to this case, there are others in various stages, either in the courts or in some preliminary stage, pending a final disposition of the issues involved. Because of the number of companies subject to the Act, vast sums of money are involved throughout all of the Circuits[1] and it

[1] The increase in loading for the years 1964 through 1966 alone was estimated to be in excess of $213 million. *See* Petition for Certiorari at 20, *Franklin Life Insurance Company* v. *United States*, cert. denied, 393 U.S. 1118 (1969).

is imperative that the controversy be settled by this Court in order that much needless litigation be eliminated.

3. With all due respect to the members of the United States Court of Appeals for the Sixth Circuit, a reading of its opinion in this case reveals that it is based purely on the prior cited decisions in the Fourth, Fifth and Seventh Circuits, with no independent consideration of the basis of the lower court's rationale, and no consideration of the arguments in the petitioner's brief showing the error of the earlier Circuit Courts' decisions. Even worse, it is apparent that the decision is based on a statement of fact erroneously deduced by the Court of Appeals in direct contradiction to the stipulation of the parties and the evidence in the record, namely, that in computing its reserves as required in the annual N.A.I.C. statement and its tax returns, the petitioner assumes the collection of the gross amount of unpaid premiums (Appendix A, *infra*, p. 15). Not only is there no such evidence in the record, the evidence presented in Court and the stipulation executed by the petitioner and by the government through their respective counsel clearly establishes exactly the contrary (R. pp. 27-28, 156-57; Appendix B, *infra*, p. 37).

CONCLUSION

Life insurance companies in those Circuits which have not ruled on the issues involved will undoubtedly continue to contest in the Tax Court the treatment of loading on unpaid premiums, in light of the conviction of the members of that Court expressed in their decision below. In addition the issues will be litigated in the United States District Courts in those circuits. Within one month of the publication of the Decision rendered by the Sixth Circuit in this case, litigation involving similar issues was commenced in

one of the United States District Courts within the Eighth Circuit. *General American Life Insurance Co.* v. *United States,* Civil No. 72-C-374 (3) (E.D. Mo., filed June 15, 1972); *see also United Life and Accident Insurance Co.* v. *United States of America,* 329 F. Supp. 765 (D.N.H. 1971). The issue will also be litigated in the Fifth Circuit in view of its decision in the *Liberty National* case, *supra.* Thus, the issues will continue to be raised in the Circuits, one at a time, unless this Court now resolves any and all conflicts. That needless litigation can be eliminated by action by this Court in the present case, and the conflict in the Fifth Circuit and the errors by the Fourth, Sixth and Seventh Circuits can be corrected once and for all.

Therefore, it is urged that this petition for a writ of certiorari should be granted.

Respectfully submitted,

Alan R. Vogeler

ALAN R. VOGELER
1313 Provident Tower
Cincinnati, Ohio 45202
Counsel for Petitioner

OF COUNSEL:

GERALD L. BALDWIN
Kyte, Conlan, Wulsin & Vogeler
1313 Provident Tower
Cincinnati, Ohio 45202

ARTHUR K. MASON
1225 19th St. N.W.
Washington, D.C. 20036

October 6, 1972.

CERTIFICATE OF SERVICE

It is hereby certified that service of the foregoing Petition for certiorari has been made pursuant to paragraphs 1 and 2 of Rule 33 of the Revised Rules of the Supreme Court of the United States by mailing three copies thereof on this 5th day of October, 1972, in an envelope with air mail postage prepaid, properly addressed to the Solicitor General, Department of Justice, Washington, D. C. 20530, and Mr. Fred B. Ugast, Acting Assistant Attorney General, Tax Division, Department of Justice, Washington, D. C. 20530, Counsel for Respondent, and Messrs. William B. Harman, Kenneth L. Kimble and William T. Gibb, 1701 K Street, N.W., Washington, D. C. 20006, Counsel for *Amici Curiae*.

Alan R. Vogeler

ALAN R. VOGELER
Counsel for Petitioner

APPENDIX A

No. 71-1605

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

WESTERN AND SOUTHERN LIFE INSURANCE COMPANY,

Petitioner-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant.

Petition to review a decision of the Tax Court.

Decided and Filed May 12, 1972.

Before: CELEBREZZE and KENT, Circuit Judges, and KINNEARY*, District Judge.

KENT, Circuit Judge. This is an appeal from a decision of the Tax Court. 55 T.C. 1036. The appeal raises issues requiring the interpretation and application of the Life Insurance Company Income Tax Act of 1959, Sections 801 *et seq.*, Internal Revenue Code, 1954. 26 U.S.C. § 801 *et seq.* The Commissioner of Internal Revenue appeals from the decision of the Tax Court, which held that the appellee,

* Honorable Joseph P. Kinneary, United States District Court, Southern District of Ohio, sitting by designation.

Western and Southern Life Insurance Company (Insurance Company), in computing its taxable income under the Act, could offset the net valuation premiums on deferred and uncollected premiums and due and uncollected premiums against the reserves required by the laws of the State of Ohio to be created on the anniversary date of every policy regardless of whether premiums had been collected or not.

The Tax Court held that the Insurance Company could accrue the net valuation premium (that allocated to reserve) but was not required to accrue the "loading" portion of deferred and uncollected premiums and due and uncollected premuims The conclusion of the Tax Court resulted in a substantial reduction of the taxable income of the Insurance Company under the provisions of the Act.[1]

The basic facts are not in dispute. The taxpayer is a mutual life insurance company incorporated in Ohio. The premium paid by an insured is termed a *gross premium,* the sum of a *net* valuation premium to which is added a *loading* factor. The net valuation premium is that amount which, using the mortality table and interest rate assumed for the policy, will be sufficient to provide a reserve which will guarantee the Insurance Company's ability to pay the benefits provided by the policy. The loading factor is an amount, determined by an independent judgment of the

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[1] The Commissioner determined the following deficiencies in taxpayer's income taxes.

Taxable year ended	*Deficiency*
December 31, 1958	$ 78,486.51
December 31, 1959	143,266.71
December 31, 1960	219,300.21
December 31, 1961	476,421.04
December 31, 1962	659,724.36
Total	$1,577,198.83

insurance company, which is designed to cover estimated operating, administrative and sales expenses and profits in the case of capital stock companies and dividends in case of mutual companies. The gross premium is that annual amount which provides coverage under the policy for one year from the anniversary of the date of issuance. At the end of any taxable year there will be outstanding policies upon which the premiums have not been paid although the anniversary date will have occurred. Deferred and unpaid premiums are portions of the annual premium by contract payable in installments with installments not yet due at the end of the taxable year. Due and uncollected premiums are premiums which were due on or before the end of the taxable year but were not yet paid and the insurance remained in force because of the 31-day grace period for the payment of premiums required by statute to be provided in the policies.

Under the laws of the State of Ohio (and most other states), and pursuant to the requirements of the National Association of Insurance Commissioners (NAIC) an insurance company is obligated to establish and maintain reserves for its potential liability under all policies in force. The amount of the reserve, as required by Ohio law and the NAIC, is computed on the assumption that all gross premiums are paid on the anniversary date of the policy regardless of whether the premiums have in fact been paid. The reserves are reflected as a liability. The problem arises from the fact that the NAIC annual statement requires the taxpayer insurance company to show under assets only an amount equal to the net valuation portion of due and deferred uncollected premiums. The insurance company in turn reflects this amount in the computation of assets under Section 805 of the Act in order to arrive at taxable investment income as provided in Section 804 of the Act.

The net result of such procedure (reflection of assets at a net valuation premium value rather than a gross premium value) is to decrease the denominator of a fraction which has as a numerator the reserves and which renders the quotient to be taxed smaller.[2]

The Commissioner takes the position that life insurance companies, in making the computation to which reference has been made, should include as assets the gross premiums for all policies for which reserves are created. The Insurance Company, following the rules of the NAIC, included only the net valuation premiums. The Tax Court held contrary to the Commissioner's position as it has in other similar cases. *Western National Life Insurance Company of Texas* v. *C.I.R.*, 50 T.C. 285 (1968), *modified* 51 T.C. 824 (1969), *reversed* 432 F.2d 298 (5th Cir. 1970). The other Courts of Appeals which have considered the problem have also rejected the Tax Court's approach. *Jefferson Standard Life Insurance Company* v. *United States,* 408 F.2d 842 (4th Cir. 1969), *cert. den.* 396 U.S. 828 (1969); *Franklin Life Insurance Company* v. *United States,* 399 F.2d 757 (7th Cir. 1968), *cert. den.* 393 U.S. 1118 (1969).

Simply stated, it is the Commissioner's position that if the taxpayer is to be permitted to utilize an accrual method of accounting for one purpose (determining reserve liability) then it should be required to use the accrual method consistently throughout all other income tax computations relating to the same policies and the same premium income (actual or anticipated). It is the Commissioner's position that only in this manner will the return properly reflect the insurance company's profitability.

It is the position of the Insurance Company that there

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[2] For an excellent discussion of the computation stages and the taxable phases of this issue see *Jefferson Standard Life Insurance Company* v. *United States*, 408 F.2d 842, 844, 845 (4th Cir. 1969).

is no obligation on the part of the policyholders to pay any premiums, that it cannot be required to accrue the loading factor of premiums which the policyholder has no legal obligation to pay and the Insurance Company has no legal right to collect.

The position taken by the Commissioner is supported by the relevant Code provision, the regulations, and, as stated, the opinions of all-other Circuits which have considered these issues.

With respect to the computation of taxes, Section 818 (a) of the Act provides for an accrual method of accounting:

> § 818. **Accounting provisions**
>
> (a) **Method of accounting.**—All computations entering into the determination of the taxes imposed by this part shall be made—
>
> (1) under an accrual method of acc ing, or
>
> (2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).
>
> Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

Thus, if potential liability is to be accrued we conclude that potential profitability must also be accrued. Considering Section 818 (a) the Court of Appeals for the Fifth Circuit stated in *Western National Life Insurance Company of Texas* v. *C.I.R.*, 432 F.2d 298, 301, 302 (1970):

"We also agree with the decision in these two cases to the effect that the Congress did not adopt the N.A.I.C. form of statement for its accounting method as to determining the tax base for insurance companies. *As will appear from the statute itself, the N.A.I.C. annual statement was referred to as being the proper standard 'except as provided in the preceding sentence,' the preceding sentence providing that all computations should be under an accrual method of accounting.* In point of fact, the N.A.I.C. method is a hybrid method and not strictly an accrual method.

[3] To paraphrase what is so well stated by the Court of Appeals for the Fourth Circuit: An accrual method of accounting would not require the inclusion of any part of these deferred and uncollected premiums. *However, when the taxpayer does accrue them, we are of the view that they must be accrued in full, even though advantage of only a part of them can be used by the taxpayer in the formula that is used for determining the base of taxation.* See 408 F.2d 842, 856." (Emphasis added).

The Commissioner's position is also supported by Federal Tax Regulation 1.805-5 (a) (4) (ii) Example (1) which provides as follows:

"**Example (1).** Included in the statement of assets of P, a life insurance company, are the following items: Bonds; stocks; mortgages; home office and branch office buildings owned and wholly occupied by the company; furniture and equipment owned by the company and used in the home office and branch office buildings occupied by the company; agents' debit balances; premiums deferred and uncollected and premiums due and unpaid; bank deposits (including time deposits); and share accounts in savings and loan associations. For purposes of section 805 (b) (4) and this subparagraph, the home office and branch office buildings owned and wholly occupied by the company, and the furniture and equipment owned by the company and used by it in

connection with the operations conducted in the home office and branch office buildings occupied by the company, shall be excluded from the term 'assets' since such items are the only ones considered as being used by P in carrying on an insurance trade or business. *Accordingly*, since bonds, stocks, mortgages, agents' debit balances, *premiums deferred and uncollected and premiums due and unpaid*, bank deposits (including time deposits), and share accounts in savings and loan associations are not considered as being used by P in carrying on an insurance trade or business, they *are included within the term "assets"* and, therefore, shall be taken into account by P in determining its current earnings rate." (Emphasis added).

It also appears that in computing gain under Section 809 of the Act the inclusion of loading is clearly required by the express words of the statute:

> "(c) **Gross amount.**—For purposes of subsection (b) (1) and (2), the following items shall be taken into account:
>
> (1) **Premiums.**—*The gross amount of premiums* and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts (including contracts supplementary thereto); less return premiums, and premiums and other consideration arising out of reinsurance ceded. Except in the case of amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded, amounts returned where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management shall not be included in return premiums." (Emphasis added.)

The Regulation adopted pursuant to that section of the statute provides:

Reguation 1.809-4 (a) (1) (i):

> "(1) **Premiums.** (i) *The gross amount of all premiums* and other consideration on insurance and annuity contracts (including contracts supplementary thereto); less return premiums and premiums and other consideration arising out of reinsurance ceded. The term 'gross amount of all premiums' means the premiums and other consideration provided in the insurance or annuity contract. Thus, the amount to be taken into account shall be the total of the premiums and other consideration provided in the insurance or annuity contract without any deduction for commissions, return premiums, reinsurance, dividents [sic] to policyholders, dividends left on deposit with the company, discounts on premiums paid in advance, interest applied in reduction of premiums (whether or not required to be credited in reduction of premiums under the terms of the contract), or any other item of similar nature. Such term *includes advance premiums, premiums deferred and uncollected and premiums due and unpaid,* deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer (such as a payment or transfer of property in an assumption reinsurance transaction as defined in paragraph (a) (7) (ii) of § 1.809–5." (Emphasis added.)

Because the statutory provision and the regulation require the inclusion of loading in computing gain the Tax Court was in error in its conclusion.

In addition, as stated by the Court of Appeals for the Seventh Circuit in *Franklin Life Insurance Company* v. *United States*, 399 F.2d 757, 760 (1968):

> "The careful and detailed attention given by Congress throughout Sections 801 through 820 to definition of the particular items utilized as factors in the tax formula and in specifying and enumerating the permissible deductions and exclusions negates the existence of any

intent on the part of Congress to relegate the substantive matter of offsetting or excluding loading on deferred and uncollected premiums, with its concomitant impact on the resulting tax, to the NAIC."

In concluding that loading was includable as an asset in computing investment income pursuant to Section 804, and that the insurance company was not entitled to a deduction for an increase in loading under the provisions of Section 809, the Court said in *Franklin Life Insurance Company* v. *United States*, 399 F.2d 757, 760, 761, in regard to the inclusion of loading as an asset:

"Taxpayer seeks to justify the District Court's exclusion of loading on deferred and uncollected premiums from assets in the computation of "investment income" pursuant to Section 804 on the basis of taxpayer's obligations to policyholders, i. e., reserves. But taxpayer in computing its reserves for tax purposes did so on the assumption that on each policy anniversary the full annual premium has been received. . . .

The assumption that the annual premium has been received in full is, of course, a fiction, since annual premiums on all policies have not been received as of the end of the taxable year; rather, a portion thereof remains deferred and uncollected. The use of the fiction results in a bigger reserve liability figure and consequently bigger reserve liability deductions and exclusions than if reserves were computed on the basis of only those premiums actually received. If the fictional assumption were not indulged and only those reserves were accrued as were attributable to paid up portions of annual premiums, then the problem from an accrual standpoint would be simpler. But, Congress, apparently cognizant of the assumption upon which taxpayer and other life insurance companies compute reserves for annual statement purposes because of state statutory requirements chose to recognize such assumption in the tax formula it prescribed and to base an accrual reporting requirement on that assumption. And, the application of accrual principles

after that assumption has been made, will not permit of accrual of the entire annual reserve on one hand without incident accrual of the full annual premium. The District Court would permit the taxpayer to accrue a full year's liability without a corresponding accrual of the related year's asset in point of time. Such a result would attribute to Congress an intention that in the same statutory equations, exclusions and deductions attributable to reserves are to be based on the assumption that the annual premium is fully paid up and yet the amounts in the same equation from which these figures are to be subtracted are to be determined on the assumption that the annual premium is not fully paid up. This is, in effect, saying that Congress, when it specified accrual accounting, must have meant one rule to apply to reserve deductions and exclusions and another different accrual rule to apply to determining the amount from which the former are to be subtracted. We perceive nothing from which intent to impose such a dual standard of tax accounting can be presumed.

That the NAIC is willing to allow an admittedly overstated reserve while at the same time allowing an accounting entry with respect to assets which, while compensating *numerically* for the overstatement, does not fully account for the related asset, is of no aid to the taxpayer here. The acceptance of such an adjustment as being in accord with conservative and stringent solvency requirements does not permit of the utilization of such an approach to alter or modify the substantive provisions of a tax formula concerned with the *proportionate* relationship between assets and reserves. The gearing of the tax statute to an annual reserve requires recognition of no less than the annual premium."

And further said in regard to gain at page 760:

"Section 809 (c) (1) specifically, requires the inclusion of 'the gross amount of premiums' for the purpose of determining 'gain from operations' as defined in

Section 809(b) (1). Taxpayer concedes that the intent and purpose of the Act require that the deferred and uncollected premiums be included in income on a gross basis (which includes loading). In our view that concession leaves no basis for further controversy. This is especially so in view of the fact that Congress has provided twelve specific deductions in Section 809 but makes no provision for an offset or deduction for 'increase in loading'. And, the burden is on the taxpayer to show the express statutory authority for a deduction claimed. Equitable Life Insurance Co. of Iowa v. United States, 8 Cir., 340 F.2d 9."

We agree with and again quote the statement of the Court in *Western National Life Insurance Company of Texas* v. *C.I.R.*, 432 F.2d 298, 301, 302 (5th Cir. 1970):

"We also agree with the decisions in these two cases to the effect that the Congress did not adopt the N.A.I.C. form of statement for its accounting method as to determining the tax base for insurance companies. As will appear from the statute itself, the N.A.I.C. annual statement was referred to as being the proper standard 'except as provided in the preceding sentence,' the preceding sentence providing that all computations should be under an accrual method of accounting. In point of fact, the N.A.I.C. method is a hybrid method and not strictly an accrual method.

To paraphrase what is so well stated by the Court of Appeals for the Fourth Circuit: An accrual method of accounting would not require the inclusion of any part of these deferred and uncollected premiums. However, when the taxpayer does accrue them, we are of the view that they must be accrued in full, even though advantage of only a part of them can be used by the taxpayer in the formula that is used for determining the base of taxation. See 408 F.2d 842, 856."

For the reasons herein stated the judgment of the Tax Court is reversed and the case is remanded to that Court for further proceedings not inconsistent with this decision.

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 71-1605

THE WESTERN AND SOUTHERN LIFE INSURANCE COMPANY,

Petitioner-Appellee,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant.

Filed May 12, 1972.

Before: CELEBREZZE and KENT, Circuit Judges and KINNEARY, District Judge.

On appeal from the Tax Court of the United States.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, It is now here ordered and adjudged by this court that the decision of the said Tax Court in this cause be and the same is hereby reversed and the case remanded for further proceedings consistent with the opinion.

It is further ordered that Respondent-Appellant recover from Petitioner-Appellee the costs on appeal as itemized below.

Entered by order of the Court.
JAMES A. HIGGINS,
Clerk

COSTS: To be recovered by Appellant

Filing fee	$ 25.00
Printing	$229.10
Total	$254.10

IN THE

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 71-1605

THE WESTERN AND SOUTHERN LIFE INSURANCE COMPANY,

Appellee,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Appellant.

PETITION FOR REHEARING EN BANC

Filed May 25, 1972.

Alan R. Vogeler
1313 Provident Tower
Cincinnati, Ohio 45202

Arthur K. Mason
1225 - 19th Street, N.W.
Washington, D. C. 20036
Attorney for Appellee

Of Counsel
KYTE, CONLAN, WULSIN & VOGELER
1313 Provident Tower
Cincinnati, Ohio 45202

INTRODUCTION

The Appellee above named respectfully petitions this Honorable Court for a rehearing *en banc* of the appeal in the above-entitled cause, and in support of this petition represents to the Court as follows:

Appellee reserves its position as to each of the points raised by the appeal, but in this petition addresses itself solely to those aspects of the decision wherein it believes the Court may be convinced that its result was based upon the application of incorrect assumptions of fact and legal principles.

Appellee bases this petition upon four grounds: the Court (1) predicated its decision on an assumption of fact which is clearly erroneous; (2) failed to consider the validity of the applicable Internal Revenue Regulations; (3) did not give adequate consideration to the opinion of the Tax Court which it reversed; and (4) was unduly influenced in its decision upon similar cases decided by the Courts of Appeals for other circuits.

I. The Court Predicated Its Decision Upon an Erroneous Assumption of Fact.

At the outset of its decision, the Court states that "[t]he amount of the reserve, as required by Ohio law and the NAIC, is computed on the assumption that all gross premiums are paid on the anniversary date of the policy regardless of whether the premiums have in fact been paid." The record and decision of the Tax Court clearly establish that this statement is erroneous. In actuality, the reserve bears no relationship to the gross premium. It was proved by uncontroverted testimony that the reserve set up for each policy is computed totally without any reference to the gross premium due on that policy and that Western and Southern never assumed the receipt of the gross premium.

The reserve is that amount actuarially required to provide funds sufficient to pay the company's liability on the policy should the insured die. The State of Ohio, in which Appellee is resident, has established interest rates and mortality tables which all Ohio insurance companies must use in computing the reserve. The reserve thus computed must be carried on books of the company as a liability. The gross premium is the sum of two items: the "net valuation premium" and "loading." (R. 156-57).* The "net valuation premium" is an amount equal to the reserve. "Loading," as defined by this court, "is an amount *determined by an independent judgment of the insurance company,* which is designed to cover estimated operating, administrative and sales expenses and profits in the case of capital stock companies and dividends in the case of mutual companies." *Western and Southern Life Insurance Company* v. *Commissioner of Internal Revenue,* No. 71-1605, at p. 2 (6th Cir. 1972) (Emphasis added). The Tax Court in its Findings of Fact specifically found that "[t]he amount of 'loading' results from an independent judgment of each particular company and may vary from company to company." (R. 157). Thus, the amount of the gross premium can bear no certain relationship to the reserve; rather, the reserve is first computed independently and to it some uncertain, varying amount is added to arrive at the gross premium. To say that the amount of the gross premium received by the company has any effect on the amount of the reserve which is established on that policy is clearly in error.

Having made the assumption, contrary to fact, that the gross premium bears some relation to the reserve, the Court agreed with the Appellant's argument that the "symmetry" of the balance sheet of the company required the inclusion

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* "R" as used hereinafter means the Record Appendix.

of the gross premium (the item erroneously thought to give rise to the reserve) in the assets of the company. Appellee does not contend that the asset side of the company's balance sheet should reflect no addition to compensate for the inclusion of the reserve as a liability. But it is the position of Appellee that the item which properly offsets the reserve is the *net* valuation premium, not the *gross* premium. To understand why the net valuation premium is the proper offset, one must first understand why some type of offset is required. If insurance companies used an accounting method similar to other businesses, there would be no problem; assets and liabilities both would be accurately stated. However, state laws require companies to carry on their books as a liability a reserve (computed on the basis of standard mortality and interest tables as described above) for policies on which the company has no actual liability at the end of the year. Thus, there is a fictitiously created liability for which some fictitious offset, a non-existent asset, must be created. The National Association of Insurance Commissioners (NAIC) has determined that the logical amount to include is the net valuation premium, that portion of the premium which is determined by reference to the reserve. The effect is to arrive at a balance sheet which is nearly identical to a standard accrual method balance sheet, the only difference being the existence of a liability (the reserve) and an asset (net valuation premium) which numerically negate each other. But this Court would have the company include the gross premium in its assets. The result is to create an asset for the purpose of offsetting the reserve, which more than offsets the reserve.

The reserve represents only the possible liability of the company to pay the benefits under the policy should the insured die having paid the premium. It does not reflect in

any manner the potential liability for administrative and other expenses which will be incurred by the company should the premium be paid. It is those liabilities for which "loading" compensates. Since those liabilities are not included in the reserve, "loading" should not be included in the offsetting asset. If state law required the inclusion in the reserve of an amount to reflect the possible liability for administrative and selling expenses (those items for which "loading" compensates), then it would be logical to include "loading" as an asset. Those items bear some relationship to each other, they are equal. The "loading" portion of the gross premium which Appellant would include as an asset has no corresponding fictitious liability set up on the balance sheet. Thus inclusion of "loading" destroys the "symmetry" of the balance sheet which Appellant contends provides the basis for its inclusion.

II. The Court Failed to Consider the Validity of the Regulations Interpreting Section 805(a)(4) of the Internal Revenue Code.

Section 805 (a) (4) defines the term "assets." That section is completely silent with respect to the treatment of due and deferred premiums. Because the company has no enforceable right to collect the premiums on its policies, such premiums obviously are not within the ordinary definition of the term. Appellant attempts to support the Regulations by resort to Section 818 of the Code. That section provides that all computations will be made (1) on the accrual basis, or (2) under a combination of the accrual and another suitable method. Also, where it is consistent with the above alternatives, a company *shall* employ the NAIC method.

Preliminarily, Appellee does use the accrual method.

However, under such a method, no liability would be accrued to reflect the reserve required under state law, since no true liability exists until the premium is paid by the policyholder. Thus, the existence of the liability is not the result of the use of the accrual method of accounting required by Section 818. Sections 805 and 809 specifically require the company to include the reserve as a liability. If it were not for the existence of Sections 805 and 809, the company would not be permitted to predicate any of its federal income tax computations upon the existence of such liability. The statute does not expressly require that any corresponding increase be made to the assets of the company, but it is conceded that some addition must be made in order to prevent a distortion of the balance sheet. The Court adopts the Appellant's position that the required adjustment to assets is an amount equal to the gross premium, because (1) the gross premium is the determinative factor in the computation of the reserve and (2) the accrual method of accounting requires the addition of the item which gives rise to the fictitious liability. The first aspect of this reasoning has been discussed above and it is clear that the reserve bears absolutely no relationship to the gross premium and its receipt has not been assumed by Appellee. The latter portion of Appellant's reasoning adopted by the Court is equally faulty. It assumes that the accrual method of accounting requires the inclusion of the reserve among the liabilities of the company. As pointed out above, it is not the method of accounting employed by Appellee which results in the inclusion of the reserve, but rather Section 805 and 809. The reason for the existence of an offsetting asset is to avoid a totally distorted balance sheet. Therefore, the amount of the offset should be that amount which eliminates the distortion: the net valuation premium. Since there is no basis either in the

statute or in logic for the position taken by the Appellant in the Regulations under Section 805, such a position is invalid and that portion of the Regulations is not entitled to the weight given it by the Court.

III. The Court Failed to Give Adequate Consideration to the Opinion of the Tax Court and Was Unduly Influenced by Similar Cases Decided by the Courts of Appeals for Other Circuits.

The final two grounds upon which this Petition for Rehearing is based are discussed together because of their inter-relationship. The Tax Court had upon two occasions prior to the instant case considered the issues involved herein. At the time the opinion of the Tax Court was rendered, the Court of Appeals for the Fourth, Fifth and Seventh Circuits had also ruled on the same issues, twice reversing the Tax Court's previous decisions. In spite of this history of adverse reaction by the Courts of Appeals, the entire panel of the Tax Court remained firm in their interpretation of the law; every judge agrees with the position taken by Appellee in this appeal. The Tax Court, which has considered the question three times, is made up of experts in the field of federal taxation and is not lacking in respect for the Courts of Appeals. Yet, to a man, the judges comprising that Court remain convinced of the rectitude of their decision.

This Court, however, in its decision failed to discuss the opinion of the Tax Court. It chose rather to rely completely upon the decisions of the Fourth, Fifth and Seventh Circuits. As pointed out in Appellee's Brief and in the opinion of the Tax Court, the opinions rendered by those courts indicate a definite lack of understanding of the issues. A careful, independent, step-by-step analysis is vital

to a correct comprehension of the problem. Without such an analysis, it is difficult to see the error in those decisions. By relying so heavily on the other circuits, this Court failed to exercise the requisite independent judgment.

The issues presented herein are universal to the life insurance industry. They require a final solution by the Supreme Court of the United States, rather than the piecemeal treatment to which they are presently subjected. But unless one of the Courts of Appeals rules in favor of the position urged by Appellee, it is unlikely that the issues will ever reach the Supreme Court. The offhand decision rendered by this Court decreases that likelihood even further. By becoming the fourth circuit to affirm the position taken by Appellant, the Court has seriously diminished the chance that another circuit will accept the position supported by Appellee. By affirming the decision of the Tax Court, a decision clearly supported by the law, this Court can speed the dispute to a final decision.

CONCLUSION

For the foregoing reasons, Appellee requests an opportunity for a rehearing on these points. Because of the importance of the questions presented, it is requested that the rehearing be before the entire Court, *en banc*.

Respectfully submitted,

/s/ ALAN R. VOGELER
1313 Provident Tower
Cincinnati, Ohio 45202

Arthur K. Mason
1225 19th Street, N.W.
Washington, D. C. 20036

Of Counsel
KYTE, CONLAN, WULSIN & VOGELER
1313 Provident Tower
Cincinnati, Ohio 45202

CERTIFICATE OF SERVICE

It is hereby certified that service of the foregoing Petition for Rehearing en banc has been made by mailing two copies thereof on this 25th day of May, 1972 in an envelope with postage prepaid, properly addressed to Mr. Fred B. Ugast, Acting Assistant Attorney General, Tax Division, Department of Justice, Washington, D.C. 20530, counsel for the Appellant and Messrs. William B. Harman, Jr., Kenneth L. Kimble and William T. Gibb, 1701 K Street, N.W., Washington, D.C. 20006, counsel for Amici Curiae.

/s/ ALAN R. VOGELER
Counsel for Appellee

No. 71-1605

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

WESTERN AND SOUTHERN LIFE INSURANCE COMPANY,

Appellee,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Appellant.

ORDER

Filed July 12, 1972.

Before: CELEBREZZE and KENT, Circuit Judges, and KINSEARY*, District Judge.

Appellee's petition for rehearing having come on to be considered and of the Judges of this Court who are in regular active service less than a majority having favored ordering consideration en banc,

IT IS ORDERED that the petition be and it is hereby denied.

ENTERED BY ORDER OF THE COURT
JAMES A. HIGGINS, Clerk

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* Honorable Joseph P. Kinsearv, United States District Court, Southern District of Ohio, sitting by designation.

APPENDIX B

55 T. C. No. 96

UNITED STATES TAX COURT

WESTERN AND SOUTHERN LIFE INSURANCE COMPANY, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 4223-69. Filed March 23, 1971.

Petitioner, a life insurance company, is entitled to exclude the loading portion of "deferred and uncollected premiums" and "due and unpaid premiums" in computing "assets" under sec. 805(b)(4), I.R.C. 1954, and "gross amount of premiums" for the purposes of sec. 809(c)(1), I.R.C. 1954.

Lawrence H. Kyte, Alan R. Vogeler, and *Arthur K. Mason,* for the petitioner.

Rodney G. Haworth, for the respondent.

TANNENWALD, *Judge*: Respondent determined the following deficiencies in petitioner's income taxes:

Taxable year ended	Deficiency
December 31, 1958	$ 78,486.51
December 31, 1959	143,266.71
December 31, 1960	219,300.21
December 31, 1961	476,421.04
December 31, 1962	659,724.36
Total	$1,577,198.83

The issues involved in this case are:

(1) Whether the loading portion of "premiums, deferred and uncollected" and "premiums, due and unpaid" is excludable from assets within the meaning of section 805 (b) (4), I.R.C. 1954;[1] and

(2) Whether the increase in loading on "premiums, deferred and uncollected" and "premiums, due and unpaid" is excludable from premium income under section 809 (c) (1), or deductible from such income under section 809 (d).

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulations, together with the exhibits attached thereto, are incorporated herein by this reference.

Petitioner is an Ohio corporation having its principal office in Cincinnati, Ohio, at the time it filed its petition herein. Its Federal income tax returns for the years 1958 to 1962, inclusive, were filed with the district director of internal revenue, Cincinnati, Ohio.

Petitioner is a mutual life insurance company organized and existing under the laws of the State of Ohio. Its operations and accounts are subject to the supervision and approval of the superintendent of Insurance for the State of Ohio and, because it does business in numerous states, it is subject to periodic audit of its accounts by the National Association of Insurance Commissioners ("NAIC"), which acts on behalf of the insurance departments of the various states.

The tax returns filed in the years here involved were

[1] All references, unless otherwise specified, are to the Internal Revenue Code of 1954.

prepared on the same basis as was used on the annual statement required of life insurance companies by the NAIC, with some adjustments.

In life insurance, premiums are the agreed price for assuming and carrying the risk. Gross premium is the amount actually charged the insured and is composed of the net valuation premium and "loading." The net valuation premium on a particular policy is that amount of money which, using the mortality table and interest rate assumed for the policy, will be exactly sufficient to provide the benefits of the policy and is required by state law to be added to the policy reserve each year. "Loading" refers to an amount added to the net valuation premium for estimated administration, management, and operating expenses, contingencies, profits in the case of capital stock companies, and dividends in the case of mutual companies. The amount of "loading" results from an independent judgment of each particular company and may vary from company to company. Policyholders may pay premiums in semi-annual, quarterly, monthly, or weekly installments. An additional amount is added when an installment method of paying the premium is elected.

"Deferred and uncollected premiums" are the premiums on policies with premiums payable more often than annually which become due after December 31 of the calendar year and before the next policy anniversary date.

"Due and unpaid premiums" are premiums which are due to be paid before the end of the year, but which have not been paid by December 31. As required by law, all policies provide for a 31-day grace period for the payment of premiums after their due date, during which period the policy is carried in full force and effect.

"Deferred and uncollected premiums" and "due and

unpaid premiums" are hereinafter sometimes referred to as due and deferred premiums.[2]

There is no obligation, legal or otherwise, on an insured to pay to the insurer due and deferred premiums. If the policyholder does not pay the premium in conformity with the provisions of the policy, the policy is lapsed after the grace period and appropriate adjustments are made.

Petitioner was required by the State of Ohio and by the NAIC to compute its reserves on the great majority of its life insurance policies on the assumption that premiums were paid up one year in advance on each anniversary date commencing with the issuance date of the policy, even though premiums were not usually paid in this manner. The reserves so computed were reflected as a liability of petitioner and, as required by the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959,[3] were taken into account in the computations required under sections 805 and 809 on the Federal income tax returns filed by petitioner for the taxable years 1958 to 1962, inclusive.

The NAIC annual statement treats deferred and uncollected premiums on a net basis. Item 17, on the assets page of the balance sheet, calls for the statement of "Life insurance premiums and annuity considerations deferred and uncollected" on a net premium basis. Exhibit 13 of the annual statement, which gives the detail of the assets, sets forth deferred and uncollected premiums on a net basis. It provides for a memorandum account to show the amount of loading excluded from the deferred and uncol-

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[2] The parties have stipulated that "due and deferred premiums" should be the shorthand designation employed, but we note that the cases and the NAIC apparently refer to "deferred and uncollected premiums" as encompassing both classes of premiums.

[3] 26 U.S.C. sec. 801 *et seq.*, effective for taxable years beginning after December 31, 1957.

lected premiums. Item 16 of the liabilities page of the balance sheet calls for a statement of the " 'Cost of collection' on premiums and annuity considerations deferred and uncollected in excess of total loading thereon." As required by the NAIC annual statement, petitioner's annual statements showed net premiums deferred and uncollected as an asset. Also in conformity with the form, petitioner's annual statement did not show loading as an asset.

In the summary of operations contained in the NAIC annual statements, line 1.1, "Premiums and annuity considerations," includes deferred and uncollected premiums on a gross basis. It (line 1.1) provides for the inclusion of such premiums at gross to be added to gross premiums collected during the year less deferred and uncollected premiums at gross as of the end of the previous year. Line 17, which is the "Increase in aggregate reserve for policies and contracts with life contingencies," removes from income the net portion of the deferred and uncollected premiums. Line 25 provides for the deduction of the increase in loading on deferred and uncollected premiums and also for the deduction of cost of collection of premiums in excess of loading on deferred and uncollected premiums. In determining net gain from operations, lines 8 through 26A of the Summary of Operations list various allowable deductions, including the deduction in line 25 for increase in loading on deferred and uncollected premiums. This deduction was claimed by petitioner on its Federal income tax returns in determining its net gain from operations. Exclusive of increases in loading, the petitioner deducted all expenses actually paid or incurred each year on its NAIC annual statements and Federal income tax returns.

In its income tax returns for the years involved, petitioner did not include any due and deferred premiums as

an asset, but it now concedes that they should be so included in an amount equal to the net valuation premiums. In these returns, petitioner did include, as an income item, an amount of due and deferred premiums equal to the deductions for increase in loading and increase in reserves.

OPINION

This case presents two issues relating to the interpretation and application of the Life Insurance Company Income Tax Act of 1959. 26 U.S.C. sec. 801 *et seq.* The Act was a comprehensive revision of the prior schemes for taxing the incomes of life insurance companies. See H. Rept. No. 34, 86th Cong., 1st Sess., (1959) pp. 1-8; S. Rept. No. 291, 86th Cong., 1st Sess., (1959) pp. 1-12.

Section 802 (b) sets out a three-phase approach which is to be followed in computing a life insurance company's taxable income.[4] In arriving at taxable investment income and gain from operations, the 1959 Act recognizes that life insurance companies are legally obligated to keep policyholder reserves in order to meet future claims, that they normally add a significant portion of their investment income to these reserves, and that these annual reserve increments should not be subjected to tax. *United States* v. *Atlas Life Insurance Company*, 381 U.S. 233, 235-236

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[4] SEC. 802. TAX IMPOSED.

• • • • •

(b) Life Insurance Company Taxable Income Defined. — For purposes of this part, the term "life insurance company taxable income" means the sum of —

(1) the taxable investment income (as defined in section 804) or, if smaller, the gain from operations (as defined in section 809),

(2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus

(3) the amount subtracted from the policyholders surplus account for the taxable year, as determined under section 815.

(1965). The Act thus attempts to tax only those portions of investment income and premium income which represent profit to the company, legally available for distribution to policyholders or stockholders as dividends, as distinguished from those gains which, under state law, must be set aside to meet the company's future contractual obligations. *Jefferson Standard Life Insurance Co.* v. *United States*, 408 F. 2d 842, 844 (C.A. 4, 1969).

We note at the outset that we do not approach this case with a *tabula rasa*. Three Courts of Appeals, as well as this Court on two occasions, have decided similar cases involving one or both of the issues involved herein. *Franklin Life Insurance Company* v. *United States*, 399 F. 2d 757 (C.A. 7, 1968); *Jefferson Standard Life Insurance Co.* v. *United States, supra; Western National Life Insurance Company of Texas* v. *Commissioner*, 432 F. 2d 298 (C.A. 5, 1970), reversing and remanding 50 T.C. 285 (1968) as modified by 51 T.C. 824 (1969). In view of the detailed analysis contained in the various opinions in these cases, we are relieved of the necessity of exposition beyond what is essential to the articulation of our position herein.

The two issues requiring decision stem from certain propositions which are not in dispute: (1) that life insurance reserves are properly taken into account in computing the numerator of a fraction utilized in determining the amount to be eliminated from "investment income," subject to the so-called Phase I tax; (2) that the annual increase in such reserves is a proper deduction in determining gain from operations, which is subject to the so-called Phase II tax; (3) that such reserves include a purported liability in an amount computed on the assumption that premiums are paid up one year in advance on each anniversary date commencing with the issuance date of the policy; and (4) that, to the extent of such

amount, a liability is recognized which does not reflect the normal requirements of accrual accounting.

The first issue to be resolved is the extent to which due and deferred premiums should be taken into account in computing the amount of "assets" as defined in section 805 (b) (4),[5] an amount which is in the denominator of a fraction whose numerator includes "life insurance reserves." The fraction is a key element in determining the policyholders' share of investment income which is to be excluded from taxable investment income and consequently not subject to the so-called Phase I tax. Obviously, the smaller the denominator, the larger the fraction and therefore the greater the amount to be excluded and the smaller the amount subject to tax. Respondent argues that the word "assets" should include the gross amount of due and deferred premiums. He bases his contention on the following syllogism: (1) Life insurance reserves are included in the numerator of the fraction; (2) those reserves include an amount attributable to due and deferred premiums computed, as previously indicated, on the assumption that premiums are paid one year in advance; (3) such an assumption having furnished the underpinning for the computation of an element in the numerator of the fraction, the same assumption should control the determination of the denominator of the fraction. Or, to put it another way, respondent contends that, since the liability represented

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[5] (4) Assets. — For purposes of this part, the term "assets" means all assets of the company (including non-admitted assets), other than real and personal property (excluding money) used by it in carrying on an insurance trade or business. For purposes of this paragraph, the amount attributable to —

(A) real property and stock shall be the fair market value thereof, and

(B) any other asset shall be the adjusted basis (determined without regard to fair market value on December 31, 1958) of such asset for purposes of determining gain on sale or other disposition.

by life insurance reserves is based on the premise that the item giving rise to such liability has been received, the same premise must be utilized in computing the assets which are subject to such liability.

We think respondent's syllogism proves too much. Initially, we point out that the assumption upon which respondent relies so heavily has its roots in the procedures of the NAIC and presumably the requirements of state law with respect to the necessity of establishing reserves. There is no indication in the statute itself or the legislative history that such an assumption was the foundation for the statutory provision permitting the liability, represented by reserves allocated to due and deferred premiums, to be taken into account. See H. Rept. No. 34, *supra;* S. Rept. No. 291, *supra;* H. Rept. No. 520, 86th Cong., 1st Sess. (1959); but see *Franklin Life Insurance Company* v. *United States, supra,* 399 F. 2d at 761. Only if we were to adopt an osmotic view of legislative intent could we say that the assumption in question was the foundation for legislative action and, even in such a circumstance, we would have to extend the process of osmosis from a determination of the composition of life insurance reserves to a determination of the meaning of the word "assets." This we are not prepared to do.

Section 818 (a) specifically provides:

> SEC. 818. ACCOUNTING PROVISIONS.
>
> (a) Method of Accounting.—All computations entering into the determination of the taxes imposed by this part shall be made —
>
> (1) under an accrual method of accounting, or
>
> (2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of account-

> ing with any other method permitted by this chapter (other than the cash receipts and disbursements method).
>
> Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

It seems to us that, by virtue of this provision, Congress clearly specified that, except to the extent otherwise provided, the accrual method of accounting was to control; indeed, it emphasized its mandate in this regard by limiting the broad delegation of power to prescribe regulations to "a combination of an accrual method of accounting *with* any other method permitted by this chapter (other than the cash receipts and disbursements method)." (Emphasis added.) Neither party herein disputes the proposition that, since petitioner had no legal right to collect due and deferred premiums, they would not normally be includable under an accrual method of accounting. Indeed, were it not for the specific provisions in section 805, permitting life insurance reserves to be taken into account, the portion of those reserves attributable to the liability, which would have come into existence if and when the due and deferred premiums had been paid, would also not be recognized under the accrual method of accounting.

In view of the foregoing, we are of the opinion that the fact that Congress injected a limited modification of the normal rules of accrual accounting with respect to life insurance reserves does not justify an expansive interpretation of the word "assets" in section 805 (b) (4). To hold otherwise would in effect result in the creation for tax purposes of an otherwise nonexistent asset. In an analogous situation, we have only recently reaffirmed our refusal to permit respondent to utilize section 482 to allocate non-

existent income. *Huber Homes, Inc.*, 55 T.C. — (Jan. 6, 1971). Nor are we impressed with respondent's argument that adoption of his position is necessary to prevent distortion. In point of fact, whenever amounts are added to both a numerator and denominator, the fraction is distorted from what it would have been without the additions unless the amounts so added are in the same proportion as the other amounts utilized in determining the fraction. The siren song of symmetry which underlies respondent's argument regarding distortion is beside the point. Symmetry between income and deductions is not a necessary touchstone for determining the incidence of Federal income taxation, even where such symmetry is consistent with sound accounting practice. Cf. *Schlude* v. *Commissioner*, 372 U.S. 128 (1963); *American Automobile Assn.* v. *United States*, 367 U.S. 687, 692 (1961).

Perhaps there would be less distortion under respondent's method. Cf. our supplemental opinion in *Western National Life Insurance Company of Texas*, 51 T.C. 824 at 826-827 (1969). But this may not necessarily be so and, in any event, we are not disposed to create an accruable asset simply because the statute specifically permits an otherwise non-accruable liability to be taken into account. We so conclude, not because we consider the NAIC treatment binding upon us or respondent, but because, given the clear indication that the normal rules of accrual accounting should be applied to the taxation of life insurance companies, except as modified by statute, and the fact that the Life Insurance Company Income Tax Act of 1959 represents a carefully drawn, detailed framework of taxation in an unusually complicated area, we think that the word "assets" — a word of ordinary usage — should be given its accepted meaning. Cf. *Commissioner* v. *Brown*, 380 U.S. 563 (1965); *Hanover Bank* v. *Commissioner*, 369 U.S.

672 (1962); *University Hill Foundation*, 51 T.C. 548 (1969), on appeal (C.A. 9, July 14, 1969). In so concluding, we recognize that the three Circuit Courts of Appeals have reached a contrary decision (*Franklin Life Insurance Company* v. *United States, supra; Jefferson Standard Life Insurance Co.* v. *United States, supra; Western National Life Insurance Company of Texas* v. *Commissioner, supra*), but, after careful consideration, we respectfully decline to adopt their point of view.[6] We also recognize that the logic of our rationale is more consistent with our original decision in *Western National Life Insurance Co. of Texas*, 50 T.C. 285 (1968). However, in view of the fact that petitioner herein has conceded that due and deferred premiums should be included in "assets" to the extent of the net valuation premiums, i.e., with only the amount represented by loading excluded, we need now do no more than adhere to our supplemental decision in that case (51 T.C. 824) that the loading portion of due and deferred premiums should be excluded from "assets" as that term is used in section 805(b)(4) and we expressly leave open the question of reconsidering a return to our original position in that case. Moreover, in view of our rationale, we need not specifically address ourselves to the further argument made by petitioner that due and deferred premiums are assets, at least to the extent represented by loading, "used by it in carrying on an insurance trade or business" and/or have a zero basis so that they would,

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[6] The three circuits which have passed on this issue are the Seventh, Fourth, and Fifth. Any appeal in the instant case would normally lie to the Court of Appeals for the Sixth Circuit (section 7482), thus making our recent decision in *Jack E. Golsen*, 54 T.C. 742 (1970), on appeal (C.A. 10, May 4, 1970), inapplicable. We are not convinced that these cases are distinguishable on the ground urged by petitioner, namely, that it used a system of determining net valuation premiums different from that which the Courts of Appeals assumed was being used by the taxpayers involved therein.

in any event, not be recognized as "assets" within the meaning of section 805 (b) (4).

The second issue involved herein is whether the gross amount of due and deferred premiums should be included in "gross premiums" within the meaning of section 809 (c) (1)[7] in determining gain from operations for purposes of the so-called Phase II tax. Starting from the premise accepted by the parties that section 809 (d) specifically permits a deduction, in determining gain or loss from operations, for the net increase in life insurance reserves, respondent advances the same syllogism to support his position that the entire amount of due and deferred premiums is encompassed by the phrase "gross premiums." This Court has not yet ruled on this issue (see our supplemental opinion in *Western National Life Insurance Co. of Texas, supra*, 51 T.C. at 830) but one Circuit Court of Appeals has accepted respondent's position (*Jefferson Standard Life Insurance Co.* v. *United States, supra*) and another has indicated its agreement with this view although the particular issue was not before it and the taxpayer therein had conceded such an interpretation of the statute (see *Franklin Life Insurance Company* v. *United States, supra*, 399 F. 2d at 760). Our reasoning with respect to the includability of due and deferred premiums in "assets" for purposes of section 805 (b) (4) applies with equal force to the interpretation of section 809 (c) (1). By the same token, we note that we need not now decide whether that reasoning should be applied, in its full sweep, to the in-

[7] (c) Gross Amount. — For purposes of subsections (b) (1) and (2), the following items shall be taken into account:

(1) Premiums. — The gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts (including contracts supplementary thereto); * * *

terpretation of "gross premiums"; petitioner has conceded that, to the extent that the deduction with respect to life insurance reserves represents the net valuation portion of due and deferred premiums, an equal amount should be included in "gross premiums" for the purpose of determining gain from operations subject to the so-called Phase II tax. Accordingly, we now do no more than hold that the loading portion of due and deferred premiums should be excluded from "gross premiums" as that term is used in section 809(c)(1).

Reviewed by the Court.

Decision will be entered under Rule 50.

SIMPSON, *J.*, dissenting: In my judgment, I would reach a different conclusion than the majority in this case, although I do not disagree with it in principle.

In his second opinion in the *Western National* case (51 T.C. 824 (1969)), Judge Drennen decided to construe the term "assets," as used in section 805, in the light of the industry practice; in doing so, he recognized that he was not adopting the common usage of that term and that he was not applying the traditional concepts of accrual accounting. The life insurance business involves many concepts and practices which are peculiar to that business, and the income which should be subject to taxation cannot be determined without taking into consideration those peculiar concepts and practices. It is, moreover, a business which is generally subject to regulation by the States, and through the National Association of Insurance Commissioners, uniform standards are established. Generally speaking, Congress has laid down the rules for determining the income of life insurance companies which is subject to Federal taxation, but in many respects, such income must be determined by reliance upon the industry prac-

tices established in accordance with the regulations of the NAIC. In deciding to adopt the industry's concept of what constitutes an asset for purposes of section 805, I believe Judge Drennen acted wisely.

Nonetheless, I now believe that the time has come for us to abandon our own view of how the statute should be interpreted and to accept the views of the three Courts of Appeals. *Western National Life Insurance Company of Texas* v. *Commissioner*, 432 F. 2d 298 (C.A. 5, 1970), revg. and remg. 50 T.C. 285 (1968), as modified by 51 T.C. 824 (1969); *Jefferson Standard Life Insurance Co.* v. *United States*, 408 F. 2d 842, 844 (C.A. 4, 1969); *Franklin Life Insurance Company* v. *United States*, 399 F. 2d 757 (C.A. 7, 1968). Generally, it is our duty to decide a question in accordance with our best judgment. It would be irresponsible, in my opinion, for us to abrogate our own power to decide an issue and to accept the decision of another court merely because one other court had passed upon the question. Yet, we are not wholly free to expound the law as we may see it. Of course, we are constrained to give effect to our own precedents and to follow the decision of a circuit when the law has been established by decision of the Court of Appeals for that circuit. *Jack E. Golsen*, 54 T.C. 742 (1970), on appeal (C.A. 10, May 4, 1970). Even when the Court of Appeals has not spoken for the circuit in which the case arises, we do give serious consideration to the views of other circuits. At times, we may decide to continue to adhere to our view even though a Court of Appeals in a different circuit takes a different position. However, if many of the circuit courts adopt a position contrary to ours, there must come a time when we accede to their views, however much we may be convinced of the correctness of our view.

There is no magic in the number of three — there is no number of contrary decisions by the circuit courts which, in my view, should automatically cause us to accede to their views. When to abandon our view must depend upon the issue in controversy and other related circumstances. In this case, the issue is complex, and although I believe Judge Drennen's opinion was sound, I must recognize that it is difficult to make an overpowering argument for it. Under such circumstances, I believe that we should reconsider our position and accept the views of the circuits.

No one can predict with certainty how the Sixth Circuit will decide the issue, but we can be sure that they will give great weight to the views of the other Circuit Courts of Appeals. *Western National Life Insurance Company of Texas* v. *Commissioner, supra; Goodenow* v. *Commissioner,* 238 F. 2d 20 (C.A. 8, 1956). In view of the nature of the issue in controversy, it is difficult to demonstrate that those circuits were clearly erroneous, and it is difficult to give cogent reasons why the Sixth Circuit should not follow them. It is most unlikely that the Sixth Circuit will not adopt the same position as the other circuits.

For us to persist in our view under such circumstances forces a party to further litigation, when it should not be necessary. In this case the burden will be placed upon the Government, but in tomorrow's case, it might fall on the the taxpayer.

QUEALY, *J.*, agrees with this dissent.

UNITED STATES TAX COURT

Docket No. 4223-69

THE WESTERN AND SOUTHERN LIFE INSURANCE COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the opinion of the Court filed March 23, 1971, and the agreed computation of the tax liabilities filed by the parties, and incorporating herein the facts recited in the computation as the findings of the Court, it is

ORDERED and DECIDED: That there are deficiencies in income taxes due from the petitioner for the taxable years 1958, 1959, 1960, 1961, and 1962, in the amounts of $49,789.29, $136,028.86, $112,464.94, $154,489.58 and $513,776.04, respectively.

(Signed) THEODORE TANNENWALD, JR.
Judge.

Entered: April 15, 1971.

* * *

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the agreed computation of the parties, and that the Court may enter this decision, without prejudice to the right of either

party to contest the correctness of the decision entered herein, pursuant to the statute in such cases made and provided.

(Signed) K. MARTIN WORTHY,
Chief Counsel,
Internal Revenue Service.

/s/ ALAN R. VOGELER
Counsel for Petitioner.

APPENDIX C

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§ 802. Tax imposed

. . . .

(b) Life insurance company taxable income defined.—For purposes of this part, the term "life insurance company taxable income" means the sum of—

(1) the taxable investment income (as defined in section 804) or, if smaller, the gain from operations (as defined in section 809),

(2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus

(3) the amount subtracted from the policyholders surplus account for the taxable year, as determined under section 815.

§ 804 Taxable investment income

(a) In general.—

(1) Exclusion of policyholders' share of investment yield.—The policyholders' share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company shall not be included in taxable investment income. For purposes of the preceding sentence, the policyholders' share of any item shall be that percentage obtained by dividing the policy and other contract liability requirements by the investment yield; except that if the policy and other contract liability requirements exceed the investment yield, then the policyholders' share of any item shall be 100 percent.

(2) Taxable investment income defined.—For purposes of this part, the taxable investment income for any taxable year shall be an amount (not less than zero) equal to the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss plus the sum of the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), reduced by—

(A) the sum of—

(i) the life insurance company's share of interest which under section 103 is excluded from gross income,

(ii) the deduction for partially tax-exempt interest provided by section 242 (as modified by paragraph (3)), computed with respect to the life insurance company's share of such interest, and

(iii) the deductions for dividends received provided by sections 243, 244, and 245 (as modified by paragraph (5)) computed with respect to the life insurance company's share of the dividends received; and

(B) the small business deduction provided by paragraph (4).

For purposes of the preceding sentence, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of paragraph (1), equals 100 percent.

(3) Partially tax-exempt interest.—For purposes of this part, the deduction allowed by section 242 shall

be an amount which bears the same ratio to the amount determined under such section without regard to this paragraph as (A) the normal tax rate for the taxable year prescribed by section 11, bears to (B) the sum of the normal tax rate and the surtax rate for the taxable year prescribed by section 11.

(4) Small business deduction.—For purposes of this part, the small business deduction is an amount equal to 10 percent of the investment yield for the taxable year. The deduction under this paragraph shall not exceed $25,000.

(5) Application of section 246(b).—In applying section 246 (b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of this subsection, the limit on the aggregate amount of the deductions allowed by sections 243(a)(1), 244(a), and 245 shall be 85 percent of the taxable investment income computed without regard to the deductions allowed by such sections.

(6) Exception.—If it is established in any case that the application of the definition of taxable investment income contained in paragraph (2) results in the imposition of tax on—

(A) any interest which under section 103 is excluded from gross income,

(B) any amount of interest which under section 242 (as modified by paragraph (3)) is allowable as a deduction, or

(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by paragraph (5)) is allowable as a deduction.

adjustment shall be made to the extent necessary to prevent such imposition.

(b) **Gross investment income.**—For purposes of this part, the term "gross investment income" means the sum of the following:

(1) **Interest, etc.**—The gross amount of income from—

(A) interest, dividends, rents, and royalties,

(B) the entering into of any lease, mortgage, or other instrument or agreement from which the life insurance company derives interest, rents, or royalties, and

(C) the alteration or termination of any instrument or agreement desribed in subparagraph (B).

(2) **Short-term capital gain.**—In the case of a taxable year beginning after December 31, 1958, the amount (if any) by which the net short-term capital gain exceeds the net long-term capital loss.

(3) **Trade or business income.**—The gross income from any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner. In computing gross income under this paragraph, there shall be excluded any item described in paragraph (1).

Except as provided in paragraph (2), in computing gross investment income under this subsection, there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset.

(c) **Investment yield defined.**—For purposes of this part, the term "investment yield" means the gross investment income less the following deductions—

(1) **Investment expenses.**—Investment expenses for the taxable year. If any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed the sum of—

(A) one-fourth of one percent of the mean of the assets (as defined in section 805(b) (4)) held at the beginning and end of the taxable year,

(B) the amount of the mortgage service fees for the taxable year, plus

(C) whichever of the following is the greater:

(i) one-fourth of the amount by which the investment yield (computed without any deduction for investment expenses allowed by this paragraph) exceeds 3¾ percent of the mean of the assets (as defined in section 805 (b) (4)) held at the beginning and end of the taxable year, reduced by the amount described in subparagraph (B), or

(ii) one-fourth of one percent of the mean of the value of mortgages held at the beginning and end of the taxable year for which there are no mortgage service fees for the taxable year.

(2) **Real estate expenses.**—The amount of taxes (as provided in section 164), and other expenses, for the taxable year exclusively on or with respect to the real estate owned by the company. No deduction shall be

allowed under this paragraph for any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property.

(3) **Depreciation.**—The deduction allowed by section 167. The deduction under this paragraph and paragraph (2) on account of any real estate owned and occupied for insurance purposes in whole or in part by a life insurance company shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this sentence) as the rental value of the space not so occupied bears to the rental value of the entire property.

(4) **Depletion.**—The deduction allowed by section 611 (relating to depletion).

(5) **Trade or business deductions.**—The deductions allowed by this subtitle (without regard to this part) which are attributable to any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner; except that in computing the deduction under this paragraph—

(A) There shall be excluded losses—

(i) from (or considered as from) sales or exchanges of capital assets,

(ii) from sales or exchanges of property used in the trade or business (as defined in section 1231(b)), and

(iii) from the compulsory or involuntary conversion (as a result of destruction, in whole or in part, theft or seizure, or an exer-

cise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business (as so defined).

(B) Any item, to the extent attributable to the carrying on of the insurance business, shall not be taken into account.

(C) The deduction for net operating losses provided in section 172, and the special deductions for corporations provided in part VIII of subchapter B, shall not be allowed.

§ 805. Policy and other contract liability requirements

(a) In general.—For purposes of this part, the term "policy and other contract liability requirements" means, for any taxable year, the sum of—

(1) the adjusted life insurance reserves, multiplied by the adjusted reserves rate,

(2) the mean of the pension plan reserves at the beginning and end of the taxable year, multipled by the current earnings rate, and

(3) the interest paid.

(b) Adjusted reserves rate and earnings rates.—

(1) Adjusted reserves rate.—For purposes of this part, the adjusted reserves rate for any taxable year is the average earnings rate or, if lower, the current earnings rate.

(2) Current earnings rate.—For purposes of this part, the current earnings rate for any taxable year is the amount determined by dividing—

(A) the taxpayer's investment yield for such taxable year, by

(B) the mean of the taxpayer's assets at the beginning and end of the taxable year.

(3) **Average earnings rate.**—

(A) In general.—For purposes of this part, the average earnings rate for any taxable year is the average of the current earnings rates for such taxable year and for each of the 4 taxable years immediately preceding such taxable year (excluding any of such 4 taxable years for which the taxpayer was not an insurance company).

(B) Special rules.—For purposes of subparagraph (A)—

(i) the current earnings rate for any taxable year beginning before January 1, 1958, shall be determined as if this part (as in effect for 1958) and section 381(c) (22) applied to such taxable year, and

(ii) the current earnings rate for any taxable year of any company which, for such year, is an insurance company (but not a life insurance company) shall be determined as if this part applied to such company for such year.

(4) Assets.—For purposes of this part, the term "assets" means all assets of the company (including nonadmitted assets), other than real and personal property (excluding money) used by it in carrying on an insurance trade or business. For purposes of this paragraph, the amount attributable to—

(A) real property and stock shall be the fair market value thereof, and

(B) any other asset shall be the adjusted basis (determined without regard to fair market value on December 31, 1958), of such asset for purposes of determining gain on sale or other disposition.

(c) **Adjusted life insurance reserves.**—

(1) **Adjusted life insurance reserves defined.**—For purposes of this part, the term "adjusted life insurance reserves" means—

(A) the mean of the life insurance reserves (as defined in section 801(b)), other than pension plan reserves, at the beginning and end of the taxable year, multiplied by

(B) that percentage which equals 100 percent—

(i) increased by that percentage which is 10 times the average rate of interest assumed by the taxpayer in calculating such reserves, and

(ii) reduced by that percentage which is 10 times the adjusted reserves rate.

(2) **Average interest rate assumed.**—For purposes of this part, the average rate of interest assumed in calculating reserves shall be computed—

(A) by multiplying each assumed rate of interest by the means of the amounts of such reserves computed at that rate at the beginning and end of the taxable year, and

(B) by dividing (i) the sum of the products ascertained under subparagraph (A), by (ii) the mean of the total of such reserves at the beginning and end of the taxable year.

(d) Pension plan reserves.—

(1) Pension plan reserves defined.—For purposes of this part, the term "pension plan reserves" means that portion of the life insurance reserves which is allocable to contracts—

(A) purchased under contracts entered into with trusts which (as of the time the contracts were entered into) were deemed to be (i) trusts described in section 401(a) and exempt from tax under section 501(a), or (ii) trusts exempt from tax under section 165 of the Internal Revenue Code of 1939 or the corresponding provisions of prior revenue laws;

(B) purchased under contracts entered into under plans which (as of the time the contracts were entered into) were deemed to be plans described in section 403(a), or plans meeting the requirements of section 165(a) (3), (4), (5), and (6) of the Internal Revenue Code of 1939;

(C) provided for employees of the life insurance company under a plan which, for the taxable year, meets the requirements of section 401(a) (3), (4), (5), (6), (7), and (8); or

(D) purchased to provide retirement annuities for its employees by an organization which (as of the time the contracts were purchased) was an organization described in section 501(c) (3) which

was exempt from tax under section 501(a) or was an organization exempt from tax under section 101(6) of the Internal Revenue Code of 1939 or the corresponding provisions of prior revenue laws, or purchased to provide retirement annuities for employees described in section 403(b) (1) (A) (ii) by an employer which is a State, a political subdivision of a State, or an agency or instrumentality of any one or more of the foregoing.

(2) **Special transitional rule.**—For purposes of this part, the amount taken into account as pension plan reserves shall be—

(A) in the case of a taxable year beginning after December 31, 1957, and before January 1, 1959, zero;

(B) in the case of a taxable year beginning after December 31, 1958, and before January 1, 1960, 33 1/3 percent of the amount thereof (determined without regard to this paragraph);

(C) in the case of a taxable year beginning after December 31, 1959, and before January 1, 1961, 66 2/3 percent of the amount thereof (determined without regard to this paragraph); and

(D) in the case of a taxable year beginning after December 31, 1960, 100 percent of the amount thereof.

(e) **Interest paid.**—For purposes of this part, the interest paid for any taxable year is the sum of—

(1) **Interest on indebtedness.**—All interest for the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations

the interest on which is wholly exempt from taxation under this chapter.

(2) Amounts in the nature of interest.—All amounts in the nature of interest, whether or not guaranteed, for the taxable year on insurance or annuity contracts (including contracts supplementary thereto) which do not involve, at the time of accrual, life, health, or accident contingencies.

(3) Discount on prepaid premiums.—All amounts accrued for the taxable year for discounts in the nature of interest, whether or not guaranteed, on premiums or other consideration paid in advance on insurance or annuity contracts.

(4) Interest on certain special contingency reserves.—Interest for the taxable year on special contingency reserves under contracts of group term life insurance or group health and accident insurance which are established and maintained for the provision of insurance on retired lives, for premium stabilization, or for a combination thereof.

§ 809. In general

(a) Exclusion of share of investment yield set aside for policyholders.—

(1) Amount.—The share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company set aside for policyholders shall not be included in gain or loss from operations. For purposes of the preceding sentence, the share of any item set aside for policyholders shall be that percentage obtained by dividing the required in-

terest by the investment yield; except that if the required interest exceeds the investment yield, then the share of any item set aside for policyholders shall be 100 percent.

(2) **Required interest.**—For purposes of this part, the required interest for any taxable year is the sum of the products obtained by multiplying—

(A) each rate of interest required, or assumed by the taxpayer, in calculating the reserves described in section 810(c), by

(B) the means of the amount of such reserves computed at that rate at the beginning and end of the taxable year.

(b) **Gain and loss from operations.**—

(1) **Gain from operations defined.**—For purposes of this part, the term "gain from operations" means the amount by which the sum of the following exceeds the deductions provided by subsection (d):

(A) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received);

(B) the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss; and

(C) the sum of the items referred to in subsection (c).

(2) **Loss from operations defined.**—For purposes of this part, the term "loss from operations" means the

amount by which the sum of the deductions provided by subsection (d) exceeds the sum of—

(A) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received);

(B) the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss; and

(C) the sum of the items referred to in subsection (c).

(3) **Life insurance company's share.**—For purposes of this subpart, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of subsection (a) (1), equals 100 percent.

(4) **Exception.**—If it is established in any case that the application of the definition of gain from operations contained in paragraph (1) results in the imposition of tax on—

(A) any interest which under section 103 is excluded from gross income,

(B) any amount of interest which under section 242 (as modified by section 804(a) (3)) is allowable as a deduction, or

(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by subsection (d) (8) (B)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

(c) **Gross amount.**—For purposes of subsections (b) (1) and (2), the following items shall be taken into account:

(1) **Premiums.**—The gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts (including contracts supplementary thereto); less return premiums, and premiums and other consideration arising out of reinsurance ceded. Except in the case of amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded, amounts returned where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management shall not be included in return premiums.

(2) **Decreases in certain reserves.**—Each net decrease in reserves which is required by section 810 or 811(b)(2) to be taken into account for purposes of this paragraph.

(3) **Other amounts.**—All amounts, not included in computing investment yield and not includible under paragraph (1) or (2), which under this subtitle are includible in gross income.

Except as included in computing investment yield, there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset.

(d) **Deductions.**—For purposes of subsections (b) (1) and (2), there shall be allowed the following deductions:

(1) **Death benefits, etc.**—All claims and benefits ac-

crued, and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts (including contracts supplementary thereto).

(2) **Increases in certain reserves.**—The net increase in reserves which is required by section 810 to be taken into account for purposes of this paragraph.

(3) **Dividends to policyholders.**—The deduction for dividends to policyholders (determined under section 811(b)).

(4) **Operations loss deduction.**—The operations loss deduction (determined under section 812).

(5) **Certain nonparticipating contracts.**—An amount equal to 10 percent of the increase for the taxable year in the reserves for nonparticipating contracts or (if greater) an amount equal to 3 percent of the premiums for the taxable year (excluding that portion of the premiums which is allocable to annuity features) attributable to nonparticipating contracts (other than group contracts) which are issued or renewed for periods of 5 years or more. For purposes of this paragraph, the term "reserves for nonparticipating contracts" means such part of the life insurance reserves (excluding that portion of the reserves which is allocable to annuity features) as relates to nonparticipating contracts (other than group contracts). For purposes of this paragraph and paragraph (6), the term "premiums" means the net amount of the premiums and other consideration taken into account under subsection (c)(1).

(6) **Certain accident and health insurance and group life insurance.**—An amount equal to 2 percent of the

premiums for the taxable year attributable to accident and health insurance contracts (other than those to which paragraph (5) applies) and group life insurance contracts. The deduction under this paragraph for the taxable year and all preceding taxable years shall not exceed an amount equal to 50 percent of the premiums for the taxable year attributable to such contracts.

(7) Assumption by another person of liabilities under insurance, etc., contracts.—The consideration (other than consideration arising out of reinsurance ceded) in respect of the assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto).

(8) Tax-exempt interest, dividends, etc.—

(A) Life insurance company's share.—Each of the following items:

(i) the life insurance company's share of interest which under section 103 is excluded from gross income,

(ii) the deduction for partially tax-exempt interest provided by section 242 (as modified by section 804(a) (3)) computed with respect to the life insurance company's share of such interest, and

(iii) the deductions for dividends received provided by sections 243, 244, and 245 (as modified by subparagraph (B)) computed with respect to the life insurance company's share of the dividends received.

(B) Application of section 246(b).—In applying section 246(b) (relating to limitation on aggregate

amount of deductions for dividends received) for purposes of subparagraph (A) (iii), the limit on the aggregate amount of the deductions allowed by sections 243(a) (1), 244(a), and 245 shall be 85 percent of the gain from operations computed without regard to—

(i) the deductions provided by paragraphs (3), (5), and (6) of this subsection,

(ii) the operations loss deduction provided by section 812, and

(iii) the deductions allowed by sections 243(a)(1), 244(a), and 245,

but such limit shall not apply for any taxable year for which there is a loss from operations.

(9) Investment expenses, etc.—Investment expenses to the extent not allowed as a deduction under section 804(c) (1) in computing investment yield, and the amount (if any) by which the sum of the deductions allowable under section 804(c) exceeds the gross investment income.

(10) Small business deduction.—A small business deduction in an amount equal to the amount determined under section 804(a) (4).

(11) Certain mutualization distributions.—The amount of distributions to shareholders made in 1958, 1959, 1960, 1961 and 1962 in acquisition of stock pursuant to a plan of mutualization adopted before January 1, 1958.

(12) Other deductions.—Subject to the modifications provided by subsection (e), all other reductions allowed

under this subtitle for purposes of computing taxable income to the extent not allowed as deductions in computing investment yield.

Except as provided in paragraph (3), no amount shall be allowed as a deduction under this subsection in respect of dividends to policyholders.

(e) **Modifications.**—The modifications referred to in subsection (d) (12) are as follows:

(1) **Interest.**—In applying section 163 (relating to deduction for interest), no deduction shall be allowed for interest in respect of items described in section 810(c).

(2) **Bad debts.**—Section 166(c) (relating to reserve for bad debts) shall not apply.

(3) **Charitable, etc., contributions and gifts.**—In applying section 170—

(A) the limit on the total deductions under such section provided by section 170(b) (2) shall be 5 percent of the gain from operations computed without regard to —

(i) the deduction provided by section 170,

(ii) the deductions provided by paragraphs (3), (5), (6), and (8) of subsection (d), and

(iii) any operations loss carryback to the taxable year under section 812; and

(B) under regulations prescribed by the Secretary or his delegate, a rule similar to the rule contained in section 170(d)(2) (B) shall be applied.

(4) Amortizable bond premium.—Section 171 shall not apply.

(5) Net operating loss deduction.—Except as provided by section 844, the deduction for net operating losses provided in section 172 shall not be allowed.

(6) Partially tax-exempt interest.—The deduction for partially tax-exempt interest provided by section 242 shall not be allowed.

(7) Dividends received.—The deductions for dividends received provided by sections 243, 244, and 245 shall not be allowed.

(f) Limitation on certain deductions.—

(1) In general.—The amount of the deductions under paragraphs (3), (5), and (6) of subsection (d) shall not exceed $250,000 plus the amount (if any) by which—

(A) the gain from operations for the taxable year, computed without regard to such deductions, exceeds

(B) the taxable investment income for the taxable year.

(2) Application of limitation.—The limitation provided by paragraph (1) shall apply first to the amount of the deduction under subsection (d) (3), then to the amount of the deduction under subsection (d) (6), and finally to the amount of the deduction under subsection (d) (5).

(g) Limitations on deduction for certain mutualization distributions.—

(1) **Deduction not to reduce taxable investment income.**—The amount of the deduction under subsection (d) (11) shall not exceed the amount (if any) by which—

(A) the gain from operations for the taxable year, computed without regard to such deduction (but after the application of subsection (f)), exceeds

(B) the taxable investment income for the taxable year.

(2) **Deduction not to reduce tax below 1957 law.**—The deduction under subsection (d) (11) for the taxable year shall be allowed only to the extent that such deduction (after the application of all other deductions provided by subsection (d)) does not reduce the amount of the tax imposed by section 802 (a) (1) for such taxable year below the amount of tax which would have been imposed by section 802(a) as in effect for 1957, if this part, as in effect for 1957, applied for such taxable year.

(3) **Application of section 815.**—That portion of any distribution with respect to which a deduction is allowed under subsection (d) (11) shall not be treated as a distribution to shareholders for purposes of section 815; except that in the case of any distribution made in 1959, 1960, 1961, or 1962, such portion shall be treated as a distribution with respect to which a reduction is required under section 815(e) (2) (B).

§ 818. Accounting provisions

(a) **Method of accounting.**—All computations entering into the determination of the taxes imposed by this part shall be made—

(1) under an accrual method of accounting, or

(2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).

Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.